

Letter of Findings: 09-0402
Sales and Use Tax
For the Years 2005, 2006, and 2007

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ISSUE

I. Sales and Use Tax – Manufacturing Exemptions.

Authority: IC § 6-2.5-1-1 et seq.; IC § 6-2.5-3-4; IC § 6-2.5-5-3; IC § 6-2.5-5-5.1; IC § 6-8.1-5-1; [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-11](#); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Indiana Dep't of State Revenue v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974).

Taxpayer protests the assessment of tax on purchases of tangible personal property.

STATEMENT OF FACTS

Taxpayer is in the business of manufacturing towboats and barges in Indiana. Pursuant to an audit, the Indiana Department of Revenue ("Department") assessed Taxpayer additional use tax and interest on certain purchases during the tax years 2005, 2006, and 2007 because Taxpayer did not pay sales tax at the time of the original transactions nor did it self-assess and remit use tax to the Department.

Taxpayer timely protested the assessments. To support its protest, Taxpayer submitted pertinent documentation and directed the Department's attention to an itemized list. Prior to an administrative hearing, the Department agreed that the assessment of several items on Taxpayer's protest list (3, 4, 5, and 6) should be removed from the original assessment because Taxpayer provided sufficient documentation. Taxpayer, however, continued to protest the remaining items on its protest list. A hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Sales and Use Tax – Manufacturing Exemptions.

DISCUSSION

The Department's audit assessed Taxpayer use tax on purchases of tangible personal property. Taxpayer, to the contrary, claimed that it was entitled to the manufacturing exemptions on these purchases.

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Indiana imposes a sales tax on retail transactions and a complementary use tax on tangible personal property that is stored, used, or consumed in the state. IC § 6-2.5-1-1 et seq. Generally, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly or finishing of tangible personal property are taxable. [45 IAC 2.2-5-8\(a\)](#). An exemption from use tax is granted for transactions where the gross retail tax ("sales tax") was paid at the time of purchase pursuant to IC § 6-2.5-3-4. There are also additional exemptions from sales tax and use tax. A statute which provides a tax exemption, however, is strictly construed against the taxpayer. Indiana Dep't of State Revenue v. RCA Corp., 310 N.E.2d 96, 97 (Ind. Ct. App. 1974).

IC § 6-2.5-5-3(b) states:

Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

IC § 6-2.5-5-5.1(b) provides:

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture.

An exemption applies to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. [45 IAC 2.2-5-8\(a\)](#). Machinery, tools, and equipment are directly used in the production process if they have an immediate effect on the article being produced. [45 IAC 2.2-5-8\(c\)](#). A machine, tool, or piece of equipment has an immediate effect on the product being produced if it is an essential and integral part of an integrated process that produces the product. Id. An integrated process is one where the total production process is comprised of activities or steps that are functionally interrelated and where there is a flow of "work-in-process." [45 IAC 2.2-5-8\(c\)](#).

[45 IAC 2.2-5-8\(k\)](#) describes direct production as the performance of an integrated series of operations which transforms the matter into a form, composition or character different from that in which it was acquired, and that the change must be substantial resulting in a transformation of the property into a different and distinct product.

The exemption for direct use in production is further explained at [45 IAC 2.2-5-11](#), in part, as follows:

(a) The state gross retail tax shall not apply to sales of tangible personal property to be directly used by the purchaser in the direct production or manufacture of any manufacturing or agricultural machinery, tools, and equipment described in [IC 6-2.5-5-2](#) or 6-2.5-5-3 [[IC 6-2.5-5-3](#)].

(b) The exemption provided in this regulation [[45 IAC 2.2](#)] extends only to tangible personal property directly used in the direct production of manufacturing or agricultural machinery, tools, and equipment to be used by such manufacturer or producer.

(c) The state gross retail tax shall not apply to purchases of tangible personal property to be directly used by the purchaser in the production or manufacturing process of any manufacturing or agricultural machinery, tools, or equipment, provided that the machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect upon the article being produced or manufactured. The property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

(d) For the application of the rules [subsections] above, refer to Regs. 6-2.5-5-3 [[45 IAC 2.2-5-8](#) through [45 IAC 2.2-5-10](#)] with respect to tangible personal property used directly in the following activities:

pre-production and post-production activities; storage; transportation; tangible personal property which has an immediate effect upon the article produced; maintenance and replacement; testing and inspection; and managerial, sales, and other nonoperational activities.

[45 IAC 2.2-5-8](#)(d) states:

Pre-production and post-production activities. "Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.

[45 IAC 2.2-5-8](#)(f) provides:

(1) Tangible personal property used for moving raw materials to the plant prior to their entrance into the production process is taxable.

(2) Tangible personal property used for moving finished goods from the plant after manufacture is subject to tax.

(3) Transportation equipment used to transport work-in-process or semi-finished materials to or from storage is not subject to tax if the transportation is within the production process.

(4) Transportation equipment used to transport work-in-process, semi-finished, or finished goods between plants is taxable, if the plants are not part of the same integrated production process.

[45 IAC 2.2-5-8](#)(g) further states:

"Have an immediate effect upon the article being produced": Machinery, tools, and equipment which are used during the production process and which have an immediate effect upon the article being produced are exempt from tax. Component parts of a unit of machinery or equipment, which unit has an immediate effect on the article being produced, are exempt if such components are an integral part of such manufacturing unit. The fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required either by law or by practical necessity does not itself mean that the property "has an immediate effect upon the article being produced". Instead, in addition to being essential for one of the above reasons, the property must also be an integral part of an integrated process which produces tangible personal property.

Taxpayer protested seven items: (1) a crane monitoring system (LSI system), (2) a wireless wind speed indicator, (3) $\frac{3}{4}$ x 72 x 10 carbon steel, (4) $\frac{3}{4}$ x 48 x 10 carbon steel, (5) portable jib cranes and electric hoist, (6) barge barriers, and (7) portable radios.

Prior to an administrative hearing, based on the information Taxpayer submitted, the Department agreed that Taxpayer was entitled to the manufacturing exemptions on its purchases of item (3), (4), (5) and (6). Taxpayer, however, continued to protest the remainder and believed that manufacturing exemptions should apply.

At the hearing, Taxpayer briefly explained its manufacturing process based on photos and the blueprint of its shipyard. Taxpayer further provided some documentation to support the remainder of its protest.

A. Crane Monitoring System (Taxpayer's Protest Item 1)

The Department's audit agreed that Taxpayer directly used the cranes in direct production and was entitled to the manufacturing exemption. The Department, however, assessed Taxpayer use tax on its purchase of a crane monitoring system (LSI system), which Taxpayer purchased separately and installed in the cranes. Taxpayer, however, claimed that it directly used the LSI system in direct production and, therefore, it was entitled to the manufacturing exemption.

Taxpayer stated that it manufactures towboats and barges. Due to the size of the towboats and barges, Taxpayer asserted that it relied on using cranes to lift large and heavy materials during the production process. Taxpayer further illustrated that, similar to the construction industry, to better control the cranes for purposes of moving heavy and large materials safely, Taxpayer installed the LSI system. According to Taxpayer, the LSI system gave "the operator a radius reading of what footage you have when the boom is at a certain angle," so the cranes could lift the properly weighted materials without tipping the cranes over and causing damage or safety

hazards, during the production process. Thus, Taxpayer maintained that the LSI system installed in the cranes was directly used in direct production.

Taxpayer's documentation demonstrated that the LSI system was installed in the cranes to assist the operator to control the cranes and lift the materials properly during production. The application of the LSI system had an immediate impact on the operation of the cranes and was functionally interrelated to manufacture the towboats or barges.

Thus, Taxpayer has provided sufficient documentation to support its claim. The Department will recalculate the assessment in a supplemental audit.

B. Wireless Wind Speed Indicator (Taxpayer's Protest Item 2)

The Department's audit assessed Taxpayer use tax on its purchase of a wireless wind speed indicator. Taxpayer believed that "[m]anufacturer requirements dictate the precautions and processes that need to be observed based on the wind speed when the crane is operating." According to Taxpayer, "the wireless wind speed indicator [gave] the operator the wind and [provided] information on what should or should not be done at the current wind speed." Taxpayer, thus, claimed that it was entitled to the manufacturing exemption.

The fact that the wireless wind speed indicator may be considered essential to the conduct of the business of manufacturing because its use is required by practical necessity does not itself mean that the items have an immediate effect upon the article being produced. [45 IAC 2.2-5-8](#) (g). Unlike the LSI system, which was installed in the cranes to help the operator control the cranes during the production process, Taxpayer purchased the wireless wind speed indicator to collect the information on wind conditions. While Taxpayer believed that the wind speed was important to Taxpayer's production, the wireless wind speed indicator was a convenient tool for Taxpayer to gather the information, and not a tool directly used to manufacture its towboats and barges. Therefore, the Department is unable to agree with Taxpayer that it directly used the wireless wind speed indicator in direct production.

Since Taxpayer did not pay sales tax at the time of the purchase, use tax was properly imposed.

C. Portable Radios (Taxpayer's Protest Item 7)

The Department's audit assessed use tax on Taxpayer's purchases of portable radios. Taxpayer, to the contrary, claimed that it directly used the portable radios in direct production.

Taxpayer stated that "[t]he radios are necessary for the employees on the ground to direct the activities of the large rail cranes. Personnel on the ground have to be able to communicate with the operator in the crane so the operator will know where they are needed and what function they need to perform."

Similar to the above discussion in Part B, the fact that the portable radios may be considered essential to the conduct of the business of manufacturing because their use is required by practical necessity does not itself mean that the items have an immediate effect upon the article being produced. [45 IAC 2.2-5-8](#) (g). Taxpayer's employees used the radios to communicate. The use of the radios did not have an immediate effect upon the towboats or barges being produced. Therefore, the Department is unable to agree with Taxpayer that it directly used the portable radios in direct production.

Since Taxpayer did not pay sales tax at the time of the purchase, use tax was properly imposed.

In conclusion, Taxpayer's protest on item (1), (3), (4), (5) and (6) is sustained. However, Taxpayer's protest on item (2) and (7) is respectfully denied.

FINDING

Taxpayer's protest on the purchases of the wireless wind speed indicator and the portable radios, Part B and C, is respectfully denied. The remainder of Taxpayer's protest (Item 1, 3, 4, 5, and 6) is sustained. The Department will recalculate the assessment in a supplemental audit.

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